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No. 236

# In the Supreme Court of the United States

October Term, 1958

IDAHO POWER COMPANY, PETITIONER

*v.*

THE UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Court of Claims

## MEMORANDUM FOR THE UNITED STATES

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## MEMORANDUM FOR THE UNITED STATES

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### OPINIONS BELOW

The opinion and findings of fact of the Court of Claims (Pet. 1a-22a) are reported at 161 F. Supp. 807. The opinion of the Court of Claims in *Atlantic City Electric Co.* v. *United States* (Pet. 1b-12b), invoked below as controlling one of the issues involved (Pet. 2a), is reported at 161 F. Supp. 811.[1]

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[1] Taxpayer in the *Atlantic City* case filed a petition for a writ of certiorari on August 4, 1958 (No. 251, this Term).

## JURISDICTION

The order of the Court of Claims dismissing taxpayer's petition was entered on May 7, 1958. (Pet. 1a, 7a.) Taxpayer's petition for a writ of certiorari was filed on July 30, 1958. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1255(b).

## QUESTIONS PRESENTED

1. Whether the Court of Claims erred in holding that the premium paid by a public utility corporation on redemption of preferred stock was not a "dividend" within the meaning of Section 26(h) of the Internal Revenue Code of 1939, and hence did not qualify for the dividends-paid credit allowed by that provision of the Code.

2. Whether the Court of Claims erred in holding that the premium paid by a public utility corporation on a share-for-share exchange of new low-rate preferred for old high-rate preferred stock did not have the effect of the distribution of a taxable dividend under Section 112(c)(2) of the 1939 Code, and hence did not qualify for the dividends-paid credit allowed by Section 26(h).

## STATUTES INVOLVED

The statutes involved are set forth in the Appendix, *infra*, pp. 15-19.

## STATEMENT

The material facts, as found by the Court of Claims (Pet. 8a-22a), may be summarized as follows:

Taxpayer is, and in 1944 was, a public utility as defined in Section 26(h) of the Internal Revenue

Code of 1939, and its preferred stock outstanding immediately prior to August 1, 1944, was preferred stock as defined in Section 26(h). (Pet. 8a, 11a.)

Immediately prior to August 1, 1944, taxpayer had outstanding 450,000 shares of common stock, par $20 per share, which was the maximum number of shares authorized by taxpayer's certificate of organization; 28,457 shares of $6 preferred stock, no par value, as against 50,000 shares authorized; and 32,130 shares of 7% preferred stock, par $100 per share, as against 50,000 shares authorized. Taxpayer's by-laws provide that the $6 and 7% preferred stocks were redeemable upon any dividend date at $110 per share. Of the 60,587 outstanding shares of both classes of preferred, 53,287 were widely distributed among persons or corporations who did not own any of taxpayer's common stock, and the remainder were held *non-pro rata* by holders of common stock. (Pet. 11a-12a.)

On June 23, 1944, taxpayer's certificate of organization was amended to provide that after August 1, 1944, taxpayer's authorized stock should consist of 100,000 shares of 4% preferred stock, par $100 per share, and the same number of shares of common stock with the same par value as before. On the same date, taxpayer's stockholders adopted a plan to offer the holders of the old $6 and 7% preferred stock the option to exchange their holdings share-for-share for the new 4% preferred and to receive in addition to accumulated dividends a cash payment of $8 per share, or to have their stock redeemed for $110 per share plus accumulated dividends. (Pet. 11a-12a).

New by-laws were adopted by the taxpayer, effec-

tive August 1, 1944, establishing call prices for the new preferred stock varying from $104 to $106, and prohibiting the issuance of new preferred in excess of 60,587 shares without sanction by the majority of the voting power of the outstanding new preferred, unless taxpayer's earnings maintained a prescribed level with respect to taxpayer's interest and dividend obligations. (Pet. 12a-13a.)

Pursuant to the plan adopted by taxpayer's stockholders on June 23, 1944, holders of 39,587 shares of the old $6 and 7% preferred stock exchanged their holdings share-for-share for the new 4% preferred, and received in addition to accrued dividends the exchange premium of $8 per share, aggregating $316,696, which was charged on taxpayer's books to earned surplus. The remaining 21,000 shares of outstanding old preferred stock were redeemed at $110 a share, such payments aggregating $2,310,000, of which $10 per share, or a total of $210,000, represented the call or redemption premium. This redemption premium, like the exchange premium, was charged on taxpayer's books to earned surplus. (Pet. 13a-14a.)

At the beginning of 1944, taxpayer had accumulated earnings and profits of $190,297.02. Additions to earnings and profits during 1944, before federal and state taxes, totaled $1,961,646.92, for a year-end accumulated total before taxes of $2,151,943.94. After federal and state taxes, and without regard to taxpayer's claim herein, additions to earnings and profits during 1944 totaled $1,043,778.30. Taxpayer's cash distributions to preferred and common stockholders during 1944 totaled $1,604,022, of which

$526,696 represented the total of the exchange and the redemption premiums. (Pet. 16a-18a.)

In its return for 1944, taxpayer did not claim or receive any dividends paid credit under Section 26(h) of the 1939 Code either for the exchange premium or the redemption premium. (Pet. 18a.)

Having concluded in this refund suit that neither the redemption premium nor the exchange premium constituted "dividends" so as to qualify for a dividends paid credit under Section 26(h), the Court of Claims found it unnecessary to reach additional questions raised by the Government, including the question whether qualification of the redemption premium was actually in issue in this case.

## ARGUMENT

Section 26(h)(1) of the 1939 Code, App., *infra*, p. 15, provides a special credit against the income of "a public utility" for "dividends paid during the taxable year on its preferred stock." The ultimate questions in this litigation are whether the premium paid by taxpayer on the redemption of its old preferred stock, and whether the premium paid by taxpayer in connection with the share-for-share exchange of old preferred stock for new, qualify for this dividends-paid credit. It is undisputed that taxpayer was "a public utility," and that its old preferred stock was "preferred stock" within the meaning of Section 26(h); and the Court of Claims so found. (Pet. 8a, 11a.) But the Court of Claims concluded that neither the redemption premium nor the exchange premium constituted "dividends" within the meaning of Section 26(h), and hence that neither premium

qualified for the dividends-paid credit. (Pet. 1a-7a.)[2]

1. With regard to the redemption premium, the court below invoked as controlling (Pet. 2a) its decision in *Atlantic City Electric Co.* v. *United States* (Pet. 1b-12b), 161 F. Supp. 811, in concluding that the premium did not constitute Section 26(h) "dividends." In seeking review of that holding by this Court, taxpayer does not, and could not, assert a conflict. But taxpayer argues (Pet. 15-29) that the question is one of importance not heretofore decided by this Court; that the intention of Congress in enacting Section 26(h) requires the extension of the "dividends paid" credit to premiums paid on redemption of preferred stock; that, upon resort to dividend definitions outside of Section 26(h), the redemption premium in question qualifies as a "dividend" under Section 115(a), App., *infra*, p. 17; and that the limitations imposed on Section 115(a) by Section 115(c), App., *infra*, pp. 18-19, which specifically governs liquidating distributions, including distributions in redemption of stock, are inapplicable here.

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[2] Having decided both issues for the Government on this ground, the Court of Claims expressly refrained (Pet. 7a) from reaching the Government's further contentions that the court lacked jurisdiction as to the redemption premium because taxpayer's claim for refund was limited to the exchange premium, and that taxpayer's earnings and profits, properly computed, were not sufficient to cover the redemption premium and exchange premium. Should this Court grant certiorari as to either the redemption premium issue or the exchange premium issue, or both, and reverse as to either issue, or both, the case should be remanded for determination on the merits of the Government's alternative contentions.

Like contentions, addressed to the same issue, are advanced in the petition for a writ of certiorari filed by taxpayers in *General Public Utilities Corp.* v. *United States* (No. 226, this term), where the Court of Claims held, as in the case at bar, that the issue was controlled by its decision in *Atlantic City*.[3] The Government's answers to these contentions are set forth in full in its brief in opposition in *General Public Utilities*, recently filed with this Court, and accordingly will not be repeated here. For the reasons given in that brief, we submit that the instant petition should be denied insofar as it seeks review of the Court of Claims' ruling that a premium paid on redemption of preferred stock does not qualify for the dividends-paid credit under Section 26(h).

2. Taxpayer also seeks review of the holding below that the premium paid by taxpayer in connection with the share-for-share exchange of its old preferred stock for new preferred did not qualify for the Section 26(h) dividends-paid credit. It is undisputed that the transaction was tax-free under Section 112(b)(2), App. *infra*, p. 16, insofar as there was an exchange of stock for stock; and that the exchange premium constituted a concomitant distribution of "other property or money," hereinafter called boot, governed by Section 112(c), App., *infra*, pp. 16-17. However, the Court of Claims rejected the taxpayer's contention that the exchange premium had "the effect of the distribution of a taxable dividend," under

[3] That being the sole issue in *General Public Utilities*, no opinion was entered by the Court of Claims.

Section 112(c)(2) and consequently held that the premium could not qualify by that route for the "dividends-paid" credit under Section 26(h). (Pet. 2a-7a.)

Taxpayer asserts (Pet. 7-15) that this holding is in conflict with this Court's decision in *Commissioner v. Estate of Bedford*, 325 U.S. 283. The Government agrees, in the light of the considerations discussed below, that the rationale underlying the instant holding appears to be inconsistent with that of *Bedford;* that there is now considerable doubt as to the proper interpretation of Section 112(c)(2); and that the question of dividend treatment under Section 112(c)(2) is one of importance,[4] as this Court recognized in granting certiorari in *Bedford*. Accordingly, the Government does not oppose the granting of taxpayer's petition with respect to this issue.

In *Bedford*, this Court dealt with an exchange of preferred stock for new preferred stock of the same corporation, new common, and a cash payment.[5] It was undisputed that the transaction was governed by Section 112, and that the cash payment was a distribution of boot under Section 112(c) and hence a recognized gain. The question was how this recognized gain should be taxed. The taxpayer contended that the transaction was a partial liquidation under Section 115(c) and (i), App., *infra*, pp. 18-19, and

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[4] Similar language is used in Section 356(a)(2) of the Internal Revenue Code of 1954 (26 U.S.C. 1952 ed., Supp. V, Sec. 356(a)). See also Section 312(d)(1)(A) (26 U.S.C. 1952 ed., Supp. V, Sec. 312 (d)).

[5] The transaction in *Bedford* was governed by the Revenue Act of 1936, c. 690, 49 Stat. 1648, but the relevant provisions of that Act and those of the 1939 Code are identical.

hence that the gain was taxable at capital gain rates. This Court, while not denying that the transaction was in liquidation within the meaning of Section 115(c) and (j), concluded that the application of those provisions was averted since the transaction was a reorganization and hence governed by Section 112. On the other hand, it held that the definition of "dividend" in Section 115(a) is infused into Section 112(c)(2). Accordingly, it appears to have held that every distribution of boot has "the effect of the distribution of a taxable dividend" under Section 112(c)(2) to the extent that the corporate distributor has sufficient earnings and profits available for the distribution of a "dividend" as defined by Section 115(a). The Court said (p. 292):

> Treating the matter as a problem of statutory construction for our independent judgment, we hold that a distribution, pursuant to a reorganization, of earnings and profits "has the effect of a distribution of a taxable dividend" within section 112(c)(2). As is true of other teasing questions of construction raised by technical provisions of Revenue Acts the matter is not wholly free from doubt. But these doubts would have to be stronger than they are to displace the informed views of the Tax Court. And if the case can be reduced to its own particular circumstances rather than turn on a generalizing principle we should feel bound to apply *Dobson* v. *Commissioner*, 320 U.S. 489, and sustain the Tax Court.

Despite the concluding reference to *Dobson*, it would seem—and the Government understood—that

this Court was promulgating a rule of general applicability, i.e., that the availability of sufficient earnings and profits is the sole test of dividend effect under Section 112(c)(2). This construction was in harmony with the rationale, if not the square holding, of prior decisions. See, e.g., *Commissioner* v. *Owens*, 69 F. 2d 597 (C.A. 5th); *Commissioner* v. *Forhan R. Corp.*, 75 F. 2d 268 (C.A. 2d); *Rose* v. *Little Inv. Co.*, 86 F. 2d 50 (C.A. 5th); *Love* v. *Commissioner*, 113 F. 2d 236 (C.A. 3d).

Accordingly, the Government espoused this construction of Section 112(c)(2) in cases arising after *Bedford*. Indeed, it urged that there was good reason for construing Section 112(c)(2) as, in effect, an exception to the requirement of Section 115(c) that liquidating distributions be treated as capital transactions—since the dividend clause of Section 112(c)(2) would be rendered almost meaningless if, in statutory reorganizations, which often involve the liquidation of the corporate distributor, corporate earnings could be distributed and taxed at capital gain rates.

However, since *Bedford* the Government has never succeeded in having the courts accept this construction of the statute. Finally, the Second Circuit expressly refused to accept this construction in *Hawkinson* v. *Commissioner*, 235 F. 2d 747. The court said (pp. 750-751)—

> that interpretation has encountered severe criticism. Darrell, 24 Taxes 266, 271-2, 274 (1946); Wittenstein, 8 Tax L. Rev. 63 (1952). Also cited to the same proposition is *Becher* v. *C.I.R.*, 2 Cir.,

> 221 F. 2d 252. It should be noted that despite broad statements in those opinions each dealt with a pro rata distribution out of corporate earnings and profits which, consequently, had the effect of a taxable dividend. Indeed, in *Bedford* it appears that the purpose of the recapitalization was to enable the corporation under applicable state law to pay a dividend out of its current net earnings by removing a paper deficit acquired in prior years by charging stock dividends to surplus, 325 U.S. at pages 288-289, * * *. Were we faced with a case where the distribution *did not* have the effect of a taxable dividend we should find it difficult to reconcile the Commissioner's present interpretation of *Bedford* with the clear language of § 112 (c)(2). Fortunately we need not here decide the point for we conclude that the distribution in this case like the distribution in *Bedford* and *Becher did* have the effect of a taxable dividend. [Court's own italics.]

The court further held that Section 112(c)(2) and Section 115(g) (which governs stock redemptions essentially equivalent to a dividend) are *in part materia*, and, in affirming a Tax Court decision in favor of the Government, accordingly applied tests of dividend equivalence which have evolved under Section 115(g). (See *Rheinstrom* v. *Commr.*, 125 F. 2d 790 (C.A. 6th), certiorari denied, 317 U.S. 654, for a survey of the criteria of dividend equivalence under Section 115(g)).

*Hawkinson* accurately summarized the adversities which the Government's long-standing interpretation of *Bedford* has encountered. And, while there is con-

siderable force, as noted above, to the view that Section 112(c)(2) is nullified unless construed as an exception to Section 115(c), it must be conceded that the language of Section 112(c)(2) itself is somewhat difficult to reconcile with this position. It provides that if a distribution of boot—

> has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913.

Since the latter part of this provision expressly defines the role which earnings and profits shall play, it can be argued that the dividend-effect language which precedes it is mere surplusage if the sole test of such effect is the availability of earnings and profits.

*Hawkinson* was decided in 1956. In that case, as in prior cases involving the question, the taxpayers were corporate distributees who were seeking capital gain treatment of boot received, and hence were denying that sufficiency of earnings and profits is the sole test of dividend effect under Section 112(c)(2). In the case at bar—the first in which the question has arisen since *Hawkinson*—a corporate distributor is seeking a dividends-paid credit and, understandably enough, has adopted the very construction heretofore urged by the Government and opposed by taxpayers. Having for some thirteen years unsuccessfully urged the adoption of that construction in other cases, the Government, to protect the revenue,

in effect took a contrary position in this case by contending that, if its prior construction was not to be accepted when advanced on behalf of the Government, it should not be accepted at the behest of taxpayers.

However, the Government still finds it difficult, in view of the forthright language of *Bedford*, to square the reasoning of that decision with any other construction of Section 112(c)(2) than that the sufficiency of earnings and profits is the sole test of dividend effect. The Court of Claims in this case has flatly rejected that interpretation, when advanced by a taxpayer, as the Second Circuit refused to accept it when advanced by the Government. Accordingly, there is, at the least, continuing serious doubt and uncertainty besetting the question. Under the circumstances, we believe that this Court should undertake to review the question and finally settle the proper construction of Section 112(c)(2).

This Court granted certiorari under similar circumstances in *Estate of Sanford* v. *Commissioner*, 308 U.S. 39, where the Government acknowledged that its position, like the taxpayers', had varied; that there were cogent arguments on both sides of the question; and that it was unable to achieve a settled construction of the statute without the aid of this Court.

## CONCLUSION

The petition for a writ of certiorari should be denied as to the issue involving the redemption premium, and granted as to the issue involving the exchange premium.

Respectfully submitted,

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AUGUST, 1958.

## APPENDIX

Internal Revenue Code of 1939:

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(h) [As added by Sec. 133 of the Revenue Act of 1942, c. 619, 56 Stat. 798, and amended by Sec. 116 of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Credit for Dividends Paid on Certain Preferred Stock.*—

(1) *Amount of credit.*—In the case of a public utility, the amount of dividends paid during the taxable year on its preferred stock. The credit provided in this subsection shall be subtracted from the basic surtax credit provided in section 27. For the purposes of the credit provided in this subsection the amount of dividends paid shall not include any amount distributed in the current taxable year with respect to dividends unpaid and accumulated in any taxable year ending prior to October 1, 1942. Amounts distributed in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year shall for the purposes of this paragraph be deemed to be distributed with respect to the earliest year or years for which there are dividends unpaid and accumulated.

* * * * *

(26 U.S.C. 1952 ed., Sec. 26.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * *

(b) *Exchanges Solely in Kind.*—

* * * *

(2) *Stock for stock of same corporation.*—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

* * * *

(c) *Gain from Exchanges Not Solely in Kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and

profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

* * * *

(26 U.S.C. 1952 ed., Sec. 112.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) [As amended by Sec. 166 of the Revenue Act of 1942, *supra*] *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 201(c)(5), section 204(c)(11) and section 207(a)(2) and (b)(3) (where the reference is to dividends of insurance companies paid to policy holders)) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * *

(b) [As amended by Sec. 186(b) of the Revenue Act of 1942, *supra*] *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be

distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113. The preceding sentence shall not apply to a distribution which is a dividend within the meaning of the last sentence of subsection (a).

(c) [As amended by Sec. 147 of the Revenue Act of 1942, *supra*] *Distributions in Liquidation.*— Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed (whether before January 1, 1939, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. If any distribution in partial liquidation or in complete liquidation (including any one of a series of distributions made by the corporation in complete cancellation or redemption if all its stock) is made by a foreign corporation which with respect to any taxable year beginning on or before, and ending after, August 26, 1937, was a foreign

personal holding company, and with respect to which a United States group (as defined in section 331(a)(2)) existed after August 26, 1937, and before January 1, 1938, then, despite the foregoing provisions of this subsection, the gain recognized resulting from such distribution shall be considered as a gain from the sale or exchange of a capital asset held for not more than 6 months.

* * * *

(i) *Definition of Partial Liquidation.* — As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

* * * * *

(26 U.S.C. 1952 ed., Sec. 115.)

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